



Ten Little Assets

War! What is it good for?
Absolutely nothing!
Say it again y'all
War!

"War" Edwin Starr

Actually it probably is good for something – war, that is. A lot of mankind's technological advances have been bred in the bowels of wartime – radar and nuclear energy to name a few from World War II. And let's not forget Iraq's Humvee with its four-wheel consumer knock-off, the Hummer! Love those yellow Hummers rollin' down the Coast Highway – 8 miles to the gallon and all – tailgating my poor little old Mercedes and threatening to roll right over it like a Bradley tank or something. In addition, war is usually justified as a defensive move – they did that to us or could do that to us, so it's only logical we do that to them. And so it goes, and so it goes. But aside from these seemingly logical rationalities that stir jingoistic juices in a plea for our side, and a view that our dead are somehow more hallowed than their dead, I can only conclude from personal experience in Viet Nam, and redundant renderings of history books that Motown singer Edwin Starr was right – war is good for absolutely nothing.

The problem though, with this Gandhi/John Lennon "all you need is love" philosophy is that it denies the inherent genetic makeup of human nature.

Survival of the fittest is inbred in our DNA and Pollyannas who suggest that human beings are pliable and malleable like a pacifist potter's wet clay have just not joined Descartes and nearly 7 billion current participants in this 21st century Age of Reason. Still with Gandhi and Lennon in such esteemed company as Jesus and the Buddha who urged us to just give peace a chance, there must be something we can do that acknowledges our warlike genes while utilizing the rationality of progressive thinking.

The solution, quite simply, is to elect less warlike leaders, which means those with DNA tilted to nurture, as opposed to nature, which means – yes, you male chauvinist piglets – more women and fewer male presidents. I mean other than commercially sponsored and male-motivated mud wrestling, how many women do you actually see fighting each other? Behind the lines and over the cell phone, yeah sure, the backbiting can be pretty awesome, but guns and knives? Even Farrah Fawcett on Charlie's Angels just sort of pulled hair and scratched a lot of faces. Jestin' aside, however, I'm dead serious and you should be too. If we were,

dead serious, there would be a lot fewer bodies in the streets of Baghdad to name just the current hot spot. And for those of you who think that women leaders would be too soft, remember Maggie Thatcher defending the Falklands or Golda Meir leading Israel? They were tough, but neither one of them was responsible for the killing of hundreds of thousands of innocents like Saddam Hussein and _____ were. (You chastened neocons can fill in that blank.) More women leaders, fewer men is the solution if we are to avoid repeating those mistakes.¹ And while that probably means a 2½ hour State of the Union speech and a little more nurture than our collective political nature is used to, women are the ones who really understand that war is good for absolutely nothing. Say it again.

What I've been saying over and over again on the investment side is that the Fed will cut rates later this year and that their two key criteria will be employment and asset prices. With construction laborers about to hit the unemployment lines and the U rate in jeopardy of rising more than the Fed feels comfortable with, an ease as soon as mid-year may be in the cards. I have a strong sense as well, that mortgage credit availability is in the midst of a cyclical squeeze due to subprime defaults and "better late than never" moral suasion/congressional supervision of mortgage bankers. This should not only continue to floor the housing sector but dampen

consumption, as the combined effect of layoffs and Mortgage Equity Withdrawal, "withdrawal" produce a 2% or less real and a 4% or less nominal economy. Those numbers when extended for three or four quarters (which they now have been) are the stuff leading to output gaps, rising unemployment, declining inflation, and an easing in overnight Fed Funds rates.

We live in an asset based economy, however, as I've pointed out frequently in recent years' and months' *Outlooks*, and it's the increasing and in some cases bubblish trajectory of those prices that have supported the U.S. and other economies – the U.K. to name a prominent addition. Because of the importance of asset prices, the Fed has in my opinion targeted not only the standard Humphrey/Hawkins components of employment and inflation, but houses, stocks, and risk spreads of all types as indicators of the future course of the economy. They may publicly announce that higher inflation is enemy #1, but such is hard to believe with worldwide prices and the U.S. core moving towards, and in some cases resting on safe ground. It's stocks, private equities, corporate buyouts and levered risk spreads that really are front and center on the Fed's agenda because they – not CPI inflation – represent the future threat to steady growth via their exuberance.

If that is the case, observing asset price swings will be instructive, yet still not

¹ Not meant to endorse any past or future female presidential candidates living or dead. War is only one criteria for evaluation and should be considered alongside healthcare organization chart construction and commodity trading skills, to say nothing of the ability to put up with philandering husbands who themselves may have been presidential candidates in the past. Whew!

necessarily productive in front running other bond managers to lock in currently “high” yields. All of us can observe asset price ticks of all sorts and the “efficiency” of such an approach may lead to nothing other than a momentum driven, “beta” rich but “alpha-less” quest. **The secret to avoiding being a fish at the current poker table is to have a collective sense of what drives asset prices, which ones are affected first, and ultimately which ones are affected last – and to decide ahead of time whether heretofore bullish risk assets are going to correct or whether they will keep on keepin’ on.**

We at PIMCO, in our Forums and Investment Committee meetings, have a sense that in this U.S. and global cycle, perhaps more than any other previous one, it is the “carry” or perceived/expected “carry” of an asset over and above cash returns that is the driving force behind asset appreciation. Carry in this case refers to the return or yield relative to 5¼% in the U.S., 3½% in Euroland, and ½% in Japan. If greater than any of those rates in their respective markets, then it theoretically pays to continue to buy, even lever an asset in order to extract return, since volatility

and economic recessions are “history book stuff” (sic). Chart 1 shows PIMCO’s perceived asset carry path, sort of like Agatha Christie’s “Ten Little Indians” where one guest and then another was picked off by a mysterious murderer. In this case, the murderer is known ahead of time – a 5¼% overnight rate. That is the strangler that has led to the demise of at least the first four or five of our ten little assets.

The first to be knocked off was of course the Yen as it sunk lower and lower under the burden of negative dollar carry – a 500 basis point gap as recently as three months ago, and now only slightly less. Bonds then began a mild bear market as the positive carry derived from historically low Fed Funds disappeared, resulting for the past three quarters in a negative yield curve – and negative carry. Should it have been any wonder that our third “little asset” (actually a pretty big Indian by Agatha Christie standards) was an asset supersensitive to financing costs and expectations for positive total returns? Home buyers and speculators have only recently realized that not only were they in a significant negative carry position relative to realized income (rents), but

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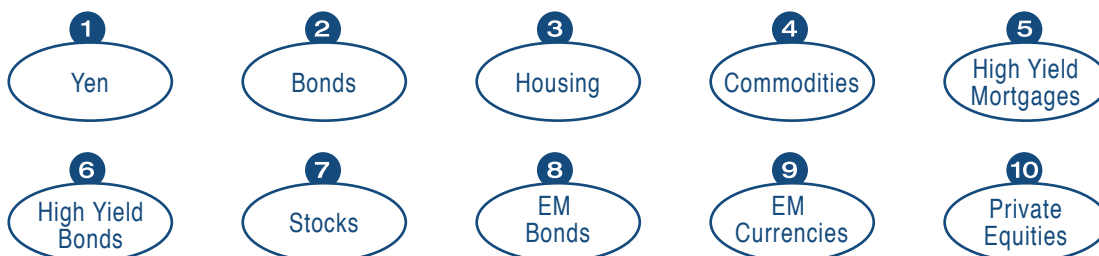


Chart 1

because houses have gone up so much in price that capital losses, not capital gains, might actually compound their negative carry. In the past few months, home prices have begun to sink YOY for the first time in decades. Commodities led by oil and copper were/are next, as futures prices in contango became negative carry relative to 5¼% cash. The High Yield asset-backed market appears to be “little asset number five” as delinquencies, defaults, and investors’ disenchantment wreak havoc with subprimes and ultimately other poorly underwritten mortgages. The Fed, while not smiling, is more than likely sitting back in a parental “I told you so” posture (actually Alan Greenspan did tell us so in a major speech concerning housing loans in late 2005). Contained “destruction” is what the Fed wants to see before short rates can be lowered.

How does this movie play out? Some would say not until the Fed raises interest rates even more. That, however, is increasingly unlikely. What the last six months have shown us is that the U.S. economy and its asset markets are sensitive to 5¼% overnight rates and that asset prices are going down – first for those categories most sensitive to negative carry, and ultimately for those whose prices have been driven so high that 5¼% represents increasing competition: earnings yields on stocks at 5-6% for example or even those historical double-digit returns from the king of them all – private equity. What the housing top proved is that any asset can eventually become overpriced and fall of

its own weight, carry or no carry. When the last of our ten little assets bites the dust is hard to know, and let me be fair – these are PIMCO’s “Ten Little Assets.” The Fed may have five, or four, and waiting for the bloom to come off the rose on the private equity bubble is probably not on Bernanke’s priority list for eventually cutting Fed Funds. But three things are, and each of them is being strangled by a currently restrictive 5¼% overnight rate: inflation, employment, and selected carry sensitive asset markets. We at PIMCO will be watching all three in an attempt to lock in yields that 12 months from now should be significantly lower, at least on the front end of the yield curve. If risk assets like stocks, emerging market and high yield bonds, as well as risk currencies such as the Brazilian Real, Mexican Peso, and New Zealand dollar begin to weaken in future weeks and months, then the Fed should know that they’ve done their job. If they’ve done it too well, and strangled the life out of all risk markets, then..., but we get ahead of ourselves. A good author/portfolio manager should know when to stop, just as I suppose, should a good President, no matter what the gender.

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